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FINANCING AGRICULTURE IN A TURBULENT WORLD ECONOMY PERSPECTIVES FROM THE U.S.A.

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ABSTRACT

About one-fifth of U.S. farmers are experiencing moderate to severe financial problems due to low income, declining land values and high interest rates. These problems are largely attributable to the world-wide economic recession of the early 1980s. U.S. agricultural lenders are struggling with record amounts of loan losses and loan servicing costs. Government policy responses have included higher price supports, farm debt restructuring and improvements in government crop insurance. Financial market innovations that would respond to income and interest rate variability include modifications to traditional farm debt instruments and improved equity capital markets for farm investments. The U.S. experience offers insights for countries that have not yet experienced the full weight of such difficulties and the solutions attempted may also be applicable elsewhere.

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Introduction

With about one-quarter of their output exported, U.S. farmers are directly affected by turbulence in the world economy. The purpose of this paper is to summarize recent agricultural credit problems in the U.S. and outline some solutions that are being explored. The U.S. experience offers insights for countries that have not yet experienced the full weight of such difficulties. The solutions attempted may also be applicable elsewhere. In the following sections, the problems of farmers and lenders are summarized, recent responses to these problems are described, and financial innovations are suggested.

Origins and Extent of Farm Financial Problems.

The agricultural recession of the 1980s is generally attributed to three factors. First, U.S. domestic prices for major agricultural export commodities declined due largely to a strong dollar and weakened demand caused by the world recession and higher debt servicing on importing countries' borrowings. Second, interest rates charged on new farm loans more than doubled between 1979 and 1981 due to restrictive monetary policies, a growing government budget deficit and financial market deregulation. Third, some parts of the U.S. experienced two or three consecutive years of adverse growing conditions.

These reversals in farmers' fortunes were especially severe because they followed seven years of virtually uninterrupted prosperity. The 1970s "boom" in U.S. agriculture that began with the massive 1973 grain sale to the USSR was characterized by low, and at times negative, real interest rates, generally rising commodity prices and sharply rising farm land values. These conditions encouraged many farmers to expand their operations with borrowed funds. By 1980, highly leveraged farming operations were vulnerable to the unforseen recession that was to follow.

Impacts on Farmers.

Falling farm incomes and land values, and rising interest rates obviously had their most severe impacts on farmers with high debt loads; however, all farmers have suffered to some degree. Melichar (Jan., 1984) estimated that by January 1, 1984, one-fifth of U.S. farmers, those with debt:asset ratios above 0.4, were experiencing financial stress. About 8 percent of all farmers had debt:asset ratios above 0.7, which is indicative of very severe financial difficulty. Financial stress in U.S. agriculture is concentrated among younger farmers with larger, "commercial" scale operations; hence, operators experiencing financial stress account for a disproportionately high share of total farm debt. The one-fifth of all farmers experiencing stress accounted for over three-fifths of total farm debt. The corollary is that over four-fifths of U.S. farmers are relatively financially secure, but less than two-fifths of total farm debt is owed by this group. Financially secure farmers generally tend to be older operators with small, part-time units.

Financial stress in agriculture has not been limited to farmers. Private and cooperatively owned farm marketing and supply firms have struggled with lower sales volume, higher interest rates and increased bad-debt losses on accounts receivable. The financial woes of multi-national companies such as International Harvester and Massey Ferguson attest to the severity of the recession on farm machinery manufacturers and dealers.

Impacts on Agricultural Lenders.

After nearly a half-century of favorable experience in farm lending , many agricultural lenders had to cope with unprecedented levels of loan losses and loan servicing costs beginning in 1981. Lenders' problems in farm lending were compounded by changing regulations and increased volatility in interest rates.

Analyses in mid-1983 (Barry and Lee; Hughes) indicated that the impacts of farm credit problems on agricultural lenders were serious but manageable. This overall assessment was still largely true as of year-end 1984, although the situation continued to deteriorate. The incidence of delinquencies, liquidations, customers discontinued, foreclosures, bankruptcies and workouts were reported at 2 to 5 times pre-1980 numbers, with wide variations geographically and between lenders. Recall, however, that pre-1980 farm loan problems were negligible when compared with nonfarm lending experience. In 1984, delinquent farm loans represented about 5 percent of total farm loans, and net farm loan charge-offs were about 1 percent of total farm loans outstanding.

Although most farm lenders have had sufficient reserves to absorb these losses, a few have failed. Of the 27 U.S. commercial banks that failed in the second quarter of 1984, 10 were agricultural banks, with farm loan:total loan ratios above

0.25. Moreover, a growing number of agricultural banks have delinquent loan volumes that exceed their capital accounts. (Melichar, October 1984).

The Cooperative Farm Credit System lenders are also experiencing difficulties, with severe problems occurring in some Production Credit Associations (PCA's). In 9 of the 12 Farm Credit Districts, at least one PCA was involved in liquidation as of mid-1984. In addition, several PCAs across the country are utilizing the system-wide loss-sharing provision developed in 1978. Under this provision, associations whose capital accounts are imperiled by loan losses receive assistance from their financially stronger counterparts.

The Farmers Home Administration (FmHA), the only government farm lender in the U.S., has experienced increased loan servicing problems, and an increased demand for new loans, consistent with their "lender of last resort" role. FmHA loans now account for over 12 percent of total farm loans outstanding, double their market share of ten years ago. Ironically, much of this growth occurred during the relatively prosperous late 1970s. Their ability to respond to the current recession has been diminished somewhat by budgetary restrictions and political pressures (Barry and Lee).

Farm financial stress has obviously created serious conflicts between borrowers and their lenders. To the extent possible, all lenders have exercised "forebearance"; every effort is made to salvage delinquent borrowers' businesses or reach mutually acceptable agreements for a voluntary full or partial liquidation. In many cases, however, foreclosure, bankruptcy or other legal remedies must be used. A few violent confrontations have attracted considerable attention from the news media, and while the numbers are small, the public has been led to believe that many young farmers are being unfairly forced out of business by their creditors.

In addition to a policy of forebearance, U.S. agricultural lenders have imposed significantly higher credit standards on new and previous borrowers. Financial ratio and cash-flow requirements used during a period of rising incomes and asset values and low interest rates proved to be too lenient in recent years. Borrowers are now asked to provide more collateral and significantly more financial information. Some farmers accuse their lenders of changing the "rules of the game". It would probably be more accurate to say that the long-standing rules of sound credit extension are now being more strictly enforced.

Government Policy Responses.

Widespread publicity coupled with the contributing roles of monetary and fiscal policies virtually demanded a response to farmers' financial problems by the government. U.S. government involvement in price and income policies was reactivated in the form of the 1983 Payment-in-Kind (PIK) program after a decade of near laissez-faire treatment of agriculture. PIK was an acreage reduction program for major crops under which producers who reduced acreage were reimbursed with actual commodities instead of direct government payments. Unfortunately, there was a major drought in 1983 and the resulting increase in commodity prices made PIK the most costly agricultural program in history--$22 billion, which was approximately equal to total U.S. net farm income that year.

In 1984, U.S. farm policy shifted to a more narrowly targeted focus on those farmers actually experiencing financial stress. The FmHA's budget was increased and a debt restructuring program was announced. The key features of debt-restructuring are:

(1) a setaside on FmHA loans of up to 25 percent (or $200,000, whichever is less) of principal and interest due for a period of up to five years,

(2) ninety percent loan guarantees for commercial lenders who permanently write off at least 10 percent of principal and interest due,

(3) expanded management and financial services for farmers and loan servicing assistance for commercial lenders from FmHA, and

(4) eligibility is limited to those who gain sufficient relief from the setaside or write off to meet projected cash flow commitments, with a 10 percent margin for unanticipated expenses. (Harl).

It remains to be seen whether a debt-restructuring program will be effective or workable. It's main advantage is that it is an attempt to reach only those who need assistance instead of increasing all farmers' incomes to save a few. At worst, it may become an administrative nightmare. Deciding who is eligible and determining which operators can meet the cash-flow feasibility test is going to be a very arbitrary procedure.

In response to crop yield variability, further modifications were made in the multiple peril crop insurance program (Lee and Djogo). The U.S. government began a limited, voluntary crop insurance program in 1938 with the creation of the Federal Crop Insurance Corporation (FCIC). Since 1980 there has been a major effort to increase participation through more individualized coverages allowing above average producers to purchase higher yield guarantees than can be obtained under the traditional area yield plan. Participation has increased in response to these modifications; however, crop insurance reduces only one of several risks facing farmers and is, therefore, only a partial solution to farm financial stress.

Financial Market Innovations

Two approaches have been suggested for improving farmers' capacities to meet cash flow commitments in the face of unstable incomes and interest rates. One is to build more flexibility into farm debt instruments. The second is to increase the flow of equity capital into financially troubled farms.

Indexed or flexible payment debt instruments would allow the debt servicing commitment to vary with net income so that cash surpluses from good years are reserved for bad ones (Lee and Baker). The common response of lenders to fluctuating interest rates has been to transfer this risk to borrowers through variable-rate loan contracts. The major problem with variable-rate lending is that the reduction in interest rate risk is largely offset by an increase in default risk. A relatively simple procedure for reducing the impacts of changing interest rates is to eliminate or minimize variations in the loan payment by allowing the loan term to vary. Most lenders could also fix interest rates by matching the term structure of their own assets and liabilities, although this is difficult to achieve in practice. The recent emergence of financial futures markets offers another method of removing interest rate risk; however, few U.S. agricultural lenders have used this tool (Heffernan).

Most farmers experiencing financial stress share a common problem--too much debt and too little equity. Since real estate dominates most farm balance sheets, infusions of equity capital require shared ownership of the land. Outside ownership of farmland is contrary to strongly held beliefs and values; however, as we have observed recently, many farm owner-operators could not tolerate the low and unstable current return to land.

Longer run financial stability in agriculture may require more separation of land ownership and management. This suggestion brings out fears of absentee, corporate or foreign ownership; however, most farm landlords in the U.S. are retired farmers or their families who reside locally. There may be cost-effective tax or other policies that would encourage more retiring farmers to leave their equity in agriculture instead of disinvesting.

Another possibility to consider is a secondary market for farm real estate. A "mutual fund"for farmland would take the lumpiness out of farmland investments. Farmers could more easily expand or contract their operations, and they could adjust their real estate holdings by exercising a buy-back clause or by purchasing shares of the fund. Owners would benefit from increased marketability and diversification. Attempts in the U.S. to use this approach failed because of strong opposition from farm organizations. The common objections are that land ownership would become concentrated in the hands of outsiders, that land prices would be unfairly bid up and that family farmers would be forced out. It can be argued, however, that just the opposite would occur. Outside equity would offer family farmers additional financial stability which would tend to keep them in business during recessions, rather than force them out.

Summary and Conclusions.

About one-fifth of U.S. farmers are experiencing moderate to severe financial stress following four years of low incomes, declining asset values and high interest rates. Although the outlook for some improvement is cautiously optimistic, no dramatic turnaround is forecast. Methods and programs for financing agriculture must address the problems of current distress as well as serve an industry that, over the long run, is characterized by income instability and low current returns to investments.

Policy responses to current problems should take the form of targeted assistance to those experiencing financial distress. Carefully designed debt restructuring and counseling on a case by case basis are possibilities. Costly programs that benefit all farmers in order to save a few should be avoided, and so too should foreclosure moratoria and other interventions that could deny lenders their legitimate rights to secured claims.

Modified debt instruments would help farmers cope with low and unstable incomes; however, long-run financial stability will depend on greater amounts of equity, not debt, capital. Tax or other incentives could be offered to retiring operators to encourage them to leave their money invested in agriculture. It may also be possible to develop a secondary market for farm real estate without compromising social and efficiency goals.

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